

**Description of the SBIC Debenture and
Participating Securities Programs**

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1	Program Overview	3
2	Program History	3
3	SBIC Instrument Characteristics.....	4
3.1	Debentures	4
3.2	Low/Moderate Income Debentures	4
3.3	Participating Securities	4
4	Business Processes	6
4.1	Licensing	6
4.2	Funding.....	7
4.3	Operations	8
4.4	Restricted Operations	8
4.5	Liquidation	8
5	Program Cash Flows	9

1 Program Overview

The purpose of the Small Business Investment Company (SBIC) program is to stimulate and supplement the flow of private equity capital and long term loans to small business concerns. The SBIC program does this by facilitating investment of long term capital in more than 400 privately owned and managed investment firms—these investment firms, in turn, provide financing to small businesses.

Financing obtained by investment firms through the SBIC program is referred to as leverage. There are two primary types of leverage:

- **Debentures.** Under the debenture program, SBICs issue debentures that are pooled into Trust Certificates and sold to investors. SBA guarantees payment of Trust Certificate coupon and principal to investors. SBICs use debenture proceeds to invest in small businesses through debt or equity instruments.
- **Participating Securities.** Under the participating securities (PS) program, SBICs issue redeemable, preferred, equity-type securities. Rights to these securities' coupon payments and principal are pooled and used to create Trust Certificates, and these Trust Certificates are sold to investors. SBA guarantees payment of Trust Certificate coupon and principal—coupon payments are referred to as prioritized payments. SBICs use proceeds of PS issues to invest in small businesses through equity or equity-type instruments.

In order to participate in the SBIC debenture or PS programs, investment firms must be licensed by SBA. SBA awards four types of SBIC licenses. Debenture SBICs are authorized to issue debentures. PS SBICs are authorized to issue PS as well as debentures. Specialized SBICs (SSBICs) are debenture SBICs that focus on investing in disadvantaged businesses.¹ Bank SBICs must abide by SBIC program investment guidelines but are not authorized to receive leverage—firms obtain bank SBIC designation largely to provide their investors with a vehicle for Community Reinvestment Act (CRA) credit.

2 Program History

The SBIC debenture program was created in 1958. Legislation creating the SBIC PS program was passed in September 1992 and the first PS were issued in February 1995. Structurally, the debenture and PS programs have remained fairly consistent over time. The most significant program changes include:

- **Changes in timing of leverage fees.** In cohorts 1992 through 1997, SBICs paid a leverage fee at disbursement. Beginning with the 1998 cohort, SBICs were required to pay 1% at commitment and 2% at the time of draw.
- **Length of disbursement period.** When the SBIC program began, commitment and disbursement were simultaneous. Beginning with the 1994 cohort, this changed such that SBICs could draw up to the end of the second fiscal year after commitment. This changed again beginning with the 1998 cohort such that SBICs could draw up to the end of the fourth fiscal year after commitment.
- **Institution of annual charge on debenture program.** There was no annual charge on leverage when the debenture or PS programs were initiated. A 1% annual charge was instituted on outstanding debenture and PS leverage beginning with the 1997 cohort.
- **Cohort-specific annual fee.** In cohorts prior to 2002, the annual fee at commitment in both the debenture and PS programs was 1%. Beginning with the 2002 cohort for PS and the

¹ Licensing of new SSBICs was discontinued as of October 1, 1996.

2001 cohort for debentures, the fee was changed to be adjustable—the fee for each cohort is calibrated to allow cohorts to be budgeted at an initial zero subsidy rate.

3 SBIC Instrument Characteristics

SBICs fund their investments in small businesses by issuing debentures or PS. These instruments are purchased and held by an interim funding provider, the Federal Home Loan Bank of Chicago (FHLBC) until they are pooled to create Trust Certificates that are sold to investors. We describe the main features of debentures and participating securities.

3.1 Debentures

Debentures are 10 year semiannual pay bullet instruments. SBICs that issue debentures are obligated to make coupon payments every six months and repay the face value of principal at maturity. SBICs may apply for debenture leverage up to three times their private capital, up to a FY 2004 cap of \$116 million. Semiannually, debentures from various issuing SBICs are pooled into Trust Certificates that in turn are sold to investors.

SBICs may prepay outstanding debentures on their semiannual payment dates by remitting the unpaid principal balance, unpaid accrued interest on the debenture, unpaid accrued SBA annual fee (if applicable), and any prepayment penalty. A linearly declining prepayment penalty is in effect over the first five years of debenture life. Partial prepayments are not allowed.

SBICs default on their debenture obligations when they fail to make a scheduled coupon payment or fail to redeem the face value of debenture principal at maturity. When default occurs, SBA generally honors its guarantee by redeeming the outstanding amount of the debenture and all unpaid interest accrued to the date of redemption. In certain cases where a SBIC fails to make a required coupon payment, SBA may simply advance the shortfall in coupon to investors rather than redeeming the debenture. SBICs are required to repay advances made on their behalf.

3.2 Low/Moderate Income Debentures

Debenture licensees are eligible to issue Low/Moderate Income (LMI) debentures. LMI debentures are generally similar to regular SBIC debentures, with several exceptions.

- Proceeds of LMI debentures must be invested in small businesses that are located primarily in qualified LMI zones or employ residents of qualified LMI zones
- LMI debentures are available in both 5 and 10 year maturities
- Interest and annual charges on LMI debentures may be deferred for the first five years of debenture life

LMI debentures are not pooled—rather, they are funded by the FHLBC throughout their entire term.

3.3 Participating Securities

PS represent redeemable, preferred, equity-type interests in SBICs. SBICs may apply for PS commitments up to two times their private capital, up to a FY 2004 cap of \$116 million. PS from various SBIC issuers are semiannually pooled into Trust Certificates that in turn are sold to investors. Proceeds of PS issuance must be invested in equity capital of portfolio companies. SBIC payment obligations on PS are somewhat different from payment obligations of PS Trust Certificates to investors—we describe PS and PS Trust Certificates characteristics separately.

3.3.1 Participating Securities Characteristics

By issuing a PS, a SBIC commits to performing any distributions from the fund according to the regulations set forth in SBA's regulations. In general, the SBIC make four types of payments to SBA:

(1) Prioritized payments SBA advances interest (known as "prioritized payments") to the participating security pool investors on a quarterly basis and is reimbursed only when an SBIC has earnings. Prioritized payments accrue from the date a PS is issued, based on the PS' outstanding principal amount. SBICs are required to make prioritized payments quarterly if they have sufficient profits available. If sufficient profits are not available, prioritized payments are deferred and payable if and when a SBIC becomes profitable. If profits are never achieved, the SBIC is not obligated to repay these prioritized payments. If profits are achieved, these payments are made first in any distribution.

(2) Fees. At commitment, SBA collects a fee from the SBIC equal to a percentage of the committed amount. When the SBIC draws on the commitment, it pays an additional 2% of the drawn amount to SBA and 0.50% of the amount to the PS underwriters. SBA also charges SBICs an annual fee as a percentage of outstanding PS principal. The annual fee rate varies by cohort. SBICs are required to pay the annual fees only upon achieving profitability—fees accrue until this time. (Cohorts 1994-1996 had no annual fees.) If an SBIC is profitable and annual fees are accrued, these are paid second in a distribution.

(3) Profit participation. In exchange for its guarantee of prioritized payments and principal on PS, SBA receives a share of SBIC profits. The profit share is calculated as:

$$\text{Profit Participation} = \text{Profit Participation Rate} \times \text{Base}$$

The Profit Participation Rate is set by regulation—it is derived from an SBIC's ratio of outstanding PS principal to leverageable capital and the yield to maturity on 10 year Treasury bonds. The Base is derived generally from the SBIC's cumulative undistributed profit to date.² If a SBIC is profitable, profit participation is paid after prioritized payments and fees.

(4) Redemption of principal. Outstanding principal is due in full on the instrument's maturity and may be redeemed on any scheduled quarterly PS payment date. There are three circumstances under which PS principal is redeemed prior to maturity:

- **Mandatory redemption** – Program regulations require that a SBIC make distributions to its private investors and to SBA if the SBIC has residual earnings after making required accrued prioritized payments and allowable tax distributions. SBA enforces this by requiring SBICs to annually evaluate their portfolios to calculate residual earnings. If residual earnings are greater than zero and the ratio of a SBIC's outstanding leverage to leverageable capital is greater than one, a portion of the SBIC's total distribution is applied to redeem PS principal, after profit participation is paid
- **Optional redemption** – SBICs have the option to redeem outstanding PS principal at any time, after all required distributions for prioritized payments, mandatory principal redemption, and profit participation have been made.
- **Forced redemption** – Certain adverse conditions may cause SBA to force redemption of an SBIC's outstanding PS principal. For example, the SBIC may become insolvent, fail to cure capital impairment in excess of allowed levels, or be found to have acted fraudulently. Under these and similar conditions, SBA redeems outstanding PS principal along with accrued

² Full detail on the calculation of the profit participation rate is available in 13 CFR 107.1530.

prioritized payments at the next payment date.³ It should be noted that the PS principal should typically be the only cash outflow at the time of redemption, since the SBA advances all prioritized payments. The SBA typically performs forced redemptions at quarterly prioritized payment dates to ensure that prioritized payments are stopped at the same time of a forced redemption.

3.3.2 Participating Security Trust Certificate Characteristics

Semiannually, PS from various SBIC issuers are pooled into Trust Certificates and the Trust Certificates sold to investors. From the perspective of the investor, PS-backed Trust Certificates are debt instruments that return two types of cash flows, prioritized payments and principal.

Prioritized payments are coupon payments that are made quarterly based on the Trust Certificate's fixed interest rate and outstanding principal. Trust Certificates are designed to pay interest only—principal is scheduled to be redeemed in full at maturity. SBA guarantees timely payment of Trust Certificate prioritized payments. In practice, SBA advances prioritized payments to PS investors on each payment date and then seeks to collect on these payments from SBICs when and if they achieve profitability.

SBA guarantees full repayment of Trust Certificate principal no later than at the instrument's maturity. Principal is redeemed more quickly when principal is redeemed on the underlying PS. This is true whether redemption on PS is mandatory, optional, or forced. Principal redemptions must occur on Trust Certificates' scheduled quarterly payment dates.

4 Business Processes

We describe four major phases of business processes within the SBIC programs: licensing, funding, operations, restricted operations, and liquidations. During the licensing phase, investment firms apply to SBA for licenses to operate as SBICs and SBA grants or denies their applications. The funding phase comprises licensed SBICs applying to SBA for leverage commitments and then drawing down on those commitments. During the operations phase, SBA monitors SBICs. SBA may place troubled PS SBICs into restricted operations to protect its interests.⁴ Finally, SBICs that default on their obligations or otherwise fail to comply with the terms of their leverage may be placed into liquidation.

4.1 Licensing

Investment funds that wish to participate in the SBIC program must be licensed by SBA. In determining whether an investment company is qualified to receive a SBIC license, SBA evaluates the investment company on a number of factors. These include:

- Investment company must be privately managed and for-profit
- Management has appropriate experience and successful investment track record
- Investment companies that wish to participate in the debenture program must have at least \$5 million in private capital
- Investment companies that wish to participate in the participating securities program must have at least \$10 million in private capital
- Investment company has diversity in its private limited partner base—no more than 70% of capital may come from a single LP

³ Under the PS program, failure of an SBIC to make prioritized payments is not a sufficient condition to force PS redemption.

⁴ Debenture SBICs are not placed into restricted operations.

- Investment company must agree to invest only in small businesses, and other constraints provided by regulation⁵

The SBIC initiates the licensing process by submitting to SBA a Management Assessment Questionnaire (MAQ). The MAQ is used as a pre-screening tool prior to the formal SBIC application. If SBA views the MAQ submission favorably, it issues a “go-forth” letter. The “go-forth” letter instructs the investment firm that it may formally apply for a license, assuming it has received minimum commitments of private capital. Minimum committed private capital is \$5 million for debenture applicants and \$10 million for PS applicants.

Applicants complete and submit a formal application for a SBIC license. The application contains information about the fund’s business plan, management expertise, ownership, and other items. SBA’s review of the application typically lasts from several months to longer. The result of the review is SBA’s decision to grant or deny the investment firm a SBIC license.

4.2 Funding

SBICs qualify for and receive funding through a multi-step process. The process is similar for both debentures and participating securities.

Step 1 – SBIC applies for commitment. SBIC submits an application for a leverage commitment to SBA. New SBICs generally submit application for commitment at time of licensing; existing SBICs must submit commitment applications in May or November. The application is reviewed by a financial analyst in the Office of SBIC Operations and the Investment Division Credit Committee.

The maximum commitment amount is two times the amount of regulatory capital, or private capital committed to the fund, up to a maximum. Commitment is valid through September 30 of the fourth full Federal fiscal year following issuance. When the commitment is approved, the SBIC is required to remit 1% of the committed amount to SBA.

Step 2 – SBIC applies to draw against commitment. SBICs may submit draw applications on 1st and 3rd Wednesday of each month. There are limits on the amount of leverage that SBICs may have outstanding at any time. For PS SBICs, outstanding leverage can be up to two times leverageable capital, up to an absolute maximum amount. For Debenture SBICs, outstanding leverage can be up to three times leverageable capital, up to an absolute maximum amount. Leverageable capital is equal to regulatory capital less unfunded commitments.

Step 3 – SBA rules on draw application. SBA approves or denies draw requests within one week after the request is submitted. For approved draw requests, SBA sends a “Notice and Confirmation” to the SBIC that indicates the approved draw amount and expiration date. Approvals of draw requests are valid for 45 days.

Step 4 – SBIC draws down funds. To draw funds, the SBIC completes and executes the “Notice and Confirmation” and sends it to the program custodian, JP Morgan Chase Bank. The custodian informs the interim funding provider, the Federal Home Loan Bank of Chicago, of the draw amount and arranges for funds to be wired the next business day—the settlement date. On the settlement date, the interim funding provider wires the gross debenture amount to the custodian, and the custodian in turn wires the funds to the SBIC, net of a 2% SBA leverage fee and a 0.50% underwriting fee. The underwriting fee is not applicable to LMI debentures.

Step 5 – Interim funding. For debentures scheduled to be pooled, interest (LIBOR + 50 bps) and the SBA annual charge accrue on the drawn amount during the interim funding

⁵ Constraints on SBIC investments are provided in 13 CFR Part 107.

period. At the time the debenture is pooled and sold, the SBIC pays accrued interest to the interim funding provider and the accrued annual charge to SBA. For PS, SBA pays LIBOR + 50 bps to the interim funding provider on the SBIC's behalf until the PS is pooled and sold. During the interim funding period for PS, SBA's annual charge is payable based on terms and conditions identical to those applicable for prioritized payments during the regular term of the instrument.

Step 6 – Debenture or participating security is pooled. Debentures are pooled semiannually, in March and September. PS are pooled semiannually in February and August. The result of pooling is the sale of 10 year Trust Certificates to institutional investors.

Prior to May 1998, SBICs could only receive funding four times per year. Starting in May 1998, SBIC funding became a real-time process—SBICs can apply to draw against outstanding commitments twice a month and drawn down on a daily basis.

4.3 Operations

The SBA Investment Division Operations branch monitors SBIC operations, financial condition, and regulatory compliance on a continuous basis. At the core of this oversight is Form 468. Form 468 provides a standard format by which SBICs submit financial statements and supplemental information to SBA. All SBICs are required to submit audited Form 468s annually, no later than one quarter after their fiscal year end. SBICs with leverage commitments outstanding are also required to submit unaudited Form 468s quarterly. The forms are submitted electronically and in hard copy.

Investment Division Operations reviews Form 468s for all SBICs. The Office of Examinations examines all SBICs annually.

4.4 Restricted Operations

SBA may place troubled PS SBICs into restricted operations. Debenture SBICs are not placed in restricted operations. During restricted operations, SBA monitors a SBIC closely and may impose operating requirements that include:

- SBIC cannot make new investments without prior SBA approval
- SBA may adjust SBIC management fees
- SBIC is restricted from making non-SBA distributions
- SBA requires that SBIC draws down unfunded private commitments

Restricting SBIC operations is intended to protect SBA's interest in the assets of the SBIC.

4.5 Liquidation

SBA may take action to liquidate assets of SBICs that default or otherwise fail to comply with the terms of their leverage, or fail to meet regulatory or financial thresholds. Regulatory triggers for liquidation may include fraud, inappropriate investments, or violation of overline limitations. Financial triggers may stem from failure to cure a condition of capital impairment, failure to pay interest on debentures, and other reasons. Several events automatically result in liquidation. These are:

- Insolvency – SBIC becomes equitably or legally insolvent
- Voluntary assignment – SBIC makes a voluntary assignment for the benefit of creditors without SBA's prior written approval
- Bankruptcy – SBIC files a petition to begin any bankruptcy or reorganization proceeding, receivership, dissolution or other similar creditors' rights proceeding, or such action is initiated against it and is not dismissed within 60 days

SBA has wide latitude to deal with SBICs in liquidation. In certain cases, SBA may allow SBICs to self-liquidate. When this occurs, the SBIC's existing management is responsible to liquidate the fund's assets—as assets are liquidated the fund repays its debt to SBA. In other cases, SBICs may reach a compromise to voluntarily assign their assets to SBA for disposal. Finally, SBA may place SBICs in receivership and use an outside management team to dispose of the SBIC's assets.

5 Program Cash Flows

Tables 1 and 2 list the major cash flows for the SBIC Debenture and Participating Securities programs.

Table 1. SBIC debenture program cash flows

Cash flow	Inflow/outflow	Description
Commitment fee	Outflow to SBIC Inflow to SBA	SBICs pay to SBA a commitment fee equal to 1% of the commitment amount at the time of commitment
Disbursement fee	Outflow to SBIC Inflow to SBA	SBICs pay to SBA a disbursement fee equal to 2% of the drawn amount at the time of draw
Annual fee	Outflow to SBIC Inflow to SBA	SBICs pay to SBA an annual fee calculated as a percentage of outstanding leverage—annual fee is payable when interest payments are due
Redemption at maturity	Outflow to SBIC Inflow to investors	SBICs are obligated to redeem debenture principal in full at maturity
Coupon payments	Outflow to SBIC Inflow to investors	SBICs must make semiannual coupon payments on outstanding debentures
Advances of coupon payments	Outflow to SBA Inflow to investors	SBA may advance debenture coupon payments if SBICs fail to make required debenture coupon payments
Recovery of advanced coupon payments	Outflow to SBIC Inflow to SBA	SBA attempts to collect on advanced debenture coupon payments from SBICs
Prepayment	Outflow to SBIC Inflow to investors	SBICs are allowed to prepay debentures in full on any semiannual payment date after interim funding
Prepayment penalty	Outflow to SBIC Inflow to investors	SBICs must pay a prepayment penalty to redeem a pooled debenture during the first half of its pooled term
Purchase	Outflow to SBA Inflow to investors	SBA purchases outstanding debenture principal and accrued interest from investors in case of default
Recovery on purchase	Inflow to SBA	SBA recovers on purchased debentures

Table 2. SBIC PS program cash flows

Cash flow	Inflow/outflow	Description
Commitment fee	Outflow to SBIC Inflow to SBA	SBICs pay to SBA a commitment fee equal to 1% of the commitment amount at the time of commitment
Disbursement fee	Outflow to SBIC Inflow to SBA	SBICs pay to SBA a disbursement fee equal to 2% of the drawn amount at the time of draw
Annual fee	Outflow to SBIC Inflow to SBA	The annual fee, calculated as a percentage of outstanding leverage, accrues and is payable when SBICs achieve profitability

Redemptions	Outflow to SBIC Inflow to investors	There are three types of redemptions: At Maturity: SBICs are obligated to redeem PS principal in full at maturity, Optional: SBICs may redeem outstanding PS principal at any time, in whole or in part, if they have fulfilled all requirements, Mandatory: SBICs are required to redeem outstanding PS principal if they meet certain requirements for retained earnings and have a ratio of leverage to leverageable capital greater than 1.
SBA advance of prioritized payments	Outflow to SBA Inflow to investors	SBA makes prioritized payments quarterly to investors on outstanding PS principal; prioritized payments accrue until they are reimbursed by the SBIC
Reimbursement of SBA advance of prioritized payments	Outflow to SBIC Inflow to SBA	As they achieve profitability, SBICs are obligated to repay to SBA accrued prioritized payments
Profit participation	Outflow to SBIC Inflow to SBA	Profitable SBICs are required to make profit participation distributions to SBA
Purchase (forced redemption)	Outflow to SBA Inflow to investors	SBA purchases outstanding PS principal, with accrued prioritized payments, when a SBIC is moved into liquidation
Recovery on purchase	Inflow to SBA	SBA recovers on purchased PS